



# SEP Plan Pitfalls (Use the IRS SEP Plan Fix-It Guide To Keep Your Clients Out Of Trouble)

Tax Exempt and Government Entities  
Employee Plans  
2009 IRS Nationwide Tax Forum

## **Slide 1**

Good morning/afternoon.

Many of you have clients who are setting money aside in a SEP retirement plan. For the next 50 minutes, we will be talking about the pitfalls that employers sometimes encounter when sponsoring a SEP. At the end of today's session, you will be able to locate the IRS SEP Fix-It Guide at [www.irs.gov/ep](http://www.irs.gov/ep) and use the Guide to help your clients find, fix and avoid common SEP plan mistakes. Let us help you help your clients keep their retirement plans running smoothly and stay a step ahead of the IRS.

We will post this presentation, along with the notes, to our web site, [www.irs.gov/ep](http://www.irs.gov/ep), in September, after the final Tax Forum in Atlanta. So if you miss anything during our discussion, please visit our web site to view the presentation.

# SEP Fix-It Guide Introduction

- Find SEP Fix-It Guide @ [www.irs.gov/ep](http://www.irs.gov/ep)
- Common mistakes
- Tips on:
  - Finding mistake
  - Corrective action/IRS Correction Program
  - Avoiding mistake
  - “More” information, including examples



## Slide 2

The SEP Fix-It Guide discusses the steps to find, fix and avoid the five most common mistakes that the IRS finds in audits of SEP retirement plans and in voluntary compliance submissions of SEPs. You can view the Guide from the Employee Plans landing page by entering [www.irs.gov/ep](http://www.irs.gov/ep) in your web browser. A link to the Fix-It Guides is located in the lower one-third of the page. Each of the potential mistakes found in the Fix-It Guide includes tips on how to find the mistake, what corrective action and IRS correction programs you can use to fix the mistake and common-sense tips on how to avoid making the mistake in the future. If you click on the hyperlinked "More" in the table, found on the first page of the Guide, you will be directed to additional information, including examples, on each of the potential mistakes.

Before we dive into the details of each mistake, let's take a few minutes to discuss an overview of SEP plans.



# SEP Plan Overview

- What is a SEP?
- How is a SEP set up?
- Which employees may participate?
- What are the contribution requirements?
- What are the basic distribution rules?
- What are the filing requirements?

### Slide 3

A SEP is a **S**implified **E**mployee **P**ension plan.

Any size business, even self-employed individuals, can establish a SEP.

There are three basic steps in setting up a SEP.

- First, the employer must execute a formal, written agreement.
- Second, the employer must give each eligible employee certain information about the SEP and
- Third, a SEP-IRA must be set up by or for each eligible employee.

The written agreement requirement can be satisfied by adopting an IRS Model SEP using Form 5305-SEP. You can simply download and print this form from the IRS web site. Your client does not need to file the form with the IRS. Using Form 5305-SEP will usually relieve the employer from filing annual retirement plan information returns with the IRS and DOL.

There are some exceptions to using Form 5305-SEP to establish a SEP plan. An employer cannot use this form if any of the following apply.

- 1) It currently maintains any other qualified retirement plan.
- 2) It has any eligible employees for whom it has not set up IRAs.
- 3) It uses the services of leased employees.
- 4) It is a member of an affiliated service group, controlled group of corporations or trades or businesses under common control, unless the eligible employees of all the members of these groups, trades or businesses participate in the SEP.

Another type of written SEP document is a prototype SEP. Financial institutions and other approved organizations can sponsor the prototype and the IRS issues opinion letters approving them. Prototype plans are then sold to individual businesses who adopt them. One other method for setting up a SEP that is not as common is for plan sponsors to adopt individually designed documents. The IRS has not established an approval process for these.

So, once the SEP document is in place, the employer must give each eligible employee a copy of the Form 5305-SEP, its instructions and the other information listed in the Form 5305-SEP instructions. An IRS Model SEP is not considered adopted until the employer gives each eligible employee this information. If the employer adopts a prototype SEP, it must give each eligible employee similar information.

Finally, a SEP-IRA must be set up by or for each employee who is eligible to be in the plan. SEP-IRAs can be set up with banks, insurance companies or other qualified financial institutions and the employer sends its SEP contributions to where the SEP-IRAs are maintained.

The employer can set up a SEP for a year as late as the due date, including extensions, of the business's income tax return for that year.

Under a SEP, the employer contributes to traditional IRAs set up for eligible employees, including self-employed individuals, subject to certain limits. A SEP is funded solely by employer contributions. So, no employee contributions are permitted. Each employee is always 100% vested in, or has ownership of, all money in his or her SEP-IRA.

Generally, any employee who performs services for the business must be included in a SEP. However, there are some exceptions to this general rule. The employer may exclude those employees who:

- Have not worked for the employer during three out of the last five years.
- Have not reached age 21.
- Are employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by the employer and the employees' union.
- Are nonresident alien employees who have no U.S. wages from the employer.
- Or employees who received less than \$550 in compensation (subject to cost-of-living adjustments) during the year. Generally, W-2 compensation will satisfy the definition of "compensation."

The SEP plan requires a SEP-IRA to hold the contributions made for each of the eligible employees. The SEP plan document will indicate the amount the employer has agreed to contribute. This amount can be discretionary, including zero. The SEP document must include a definite, written allocation formula for determining how the employer will allocate its contribution to employees' SEP-IRAs.

SEP contributions must bear a uniform relationship to compensation - meaning each employee's contribution must represent the same percentage of compensation. The amount of compensation taken into account under the plan is limited to \$245,000 in 2009, and is subject to cost-of-living adjustments for later years.

Another limit is on the total contributions to each employee's SEP-IRA. They cannot exceed the lesser of \$49,000 for 2009, or 25% of compensation. The \$49,000 is subject to cost-of-living adjustments in later years.

The employer sends the SEP contributions to the financial institution that will manage the funds. Depending on the financial institution, SEP contributions can be invested in individual stocks, mutual funds and other, similar types of investments. Each SEP participant must receive an annual statement showing the amount contributed for the year.

I wanted to talk briefly about taking money out of a SEP-IRA. Because the SEP investment vehicle is an IRA, the IRA rules apply. Employees can withdraw SEP contributions and earnings at any time. Money withdrawn is taxable in the year it is received. If an employee makes a withdrawal before he or she is age 59½, generally a 10% additional tax applies. Employees may roll over SEP contributions and earnings tax-free to other IRAs and retirement plans. SEP contributions and earnings must eventually be distributed. The law requires specific minimum amounts to be distributed each year beginning no later than April 1 of the year following the year the employee turns age 70½.

An employer generally has no filing requirements of the Form 5500-series return for a SEP. The financial institution that holds the plan's SEP-IRAs handles most of any other paperwork.



# EPCRS Overview

- Components of EPCRS
  - Self-Correction Program (SCP)
    - No IRS contact or fee
    - Insignificant failures only
  - Voluntary Correction Program (VCP)
    - IRS approval of correction, \$250 fee
  - Audit Closing Agreement Program (Audit CAP)
    - Sanction based on percentage of taxes due if plan were disqualified. Ouch!



## Slide 4

If an employer makes **insignificant** mistakes with respect to its SEP plan, it may use the IRS's Employee Plans Compliance Resolution System, or EPCRS, to remedy the mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction method should resemble one already provided for in the Code and the employer should consider all applicable facts and circumstances. Revenue Procedure 2008-50 sets forth the EPCRS, which has three components:

- **The Self-Correction Program, or SCP**, permits a plan sponsor to correct certain plan failures without contacting the IRS and without paying any fee.
- **The Voluntary Correction Program, or VCP**, permits a plan sponsor to, any time before audit, pay a fee and receive the IRS's approval for correction of plan mistakes.
- **The Audit Closing Agreement Program, or Audit CAP**, permits a plan sponsor to pay a sanction and correct a plan mistake while the plan is under audit.

In order to be eligible for the Self-Correction Program, the plan sponsor or administrator must have established formal or informal practices and procedures in place. They must be reasonably designed to promote and facilitate overall compliance with the Code. For example, the plan sponsor of a SEP may include in its plan operating manual specific steps to determine when new employees are eligible to enter the plan so that the eligibility rules of the Code are satisfied. Please remember that a plan document alone does not constitute evidence of established procedures.

SCP is available for correcting operational problems only – that is, the failure to follow the terms of the plan. SCP is not available for other types of problems, such as failing to keep the plan document up to date to reflect law changes. We will talk about this issue in more detail later in the presentation.

Under SCP, the plan sponsor corrects the mistakes using the General Correction Principles described in the EPCRS Revenue Procedure. If a plan sponsor corrects a mistake listed in, and in accordance with, the correction methods included in Appendix A or Appendix B of the Rev. Proc., it may be certain that the correction is reasonable and appropriate for the mistake.

The plan sponsor may need to make changes to its administrative procedures to ensure the mistakes don't happen again.

The SCP may be used **only** if, considering all of the facts and circumstances, the mistakes, in the aggregate, are insignificant operational failures. How do you decide if a mistake is significant or insignificant? Look at the facts and circumstances. The Revenue Procedure lists some to consider. The list is not all-inclusive. Examples include

the percentage of plan assets involved in the failure, the number of years the failure occurred and whether correction was made within a reasonable time after the discovery of the failure. If you determine the failure is insignificant, then document how you came to that decision.

When using SCP, the plan sponsor should maintain adequate records to demonstrate that they have corrected a mistake in the event of an audit of the plan.

There is no fee for self-correction.

Think of this program as similar to changing a tire on your car when you get a flat.

VCP is more like taking your car into the shop to get your brakes fixed.

*Note to Speakers: Mention streamlined procedures Appendix F – Schedule 3 for SEPs; Schedule 4 for SIMPLE IRAs – Fillable on the Internet.*

Under VCP, the plan sponsor identifies the mistakes and proposes correction using the General Correction Principles described in the EPCRS Revenue Procedure.

The plan sponsor proposes changes to its administrative procedures to ensure the mistakes do not recur and pays a compliance fee to the IRS of \$250.

The IRS issues a Compliance Statement that details the qualification mistakes identified by the plan sponsor and the correction approved by the IRS.

The plan sponsor corrects the identified mistakes within 150 days of the Compliance Statement.

While the submission is pending, Employee Plans will not examine the plan, except under unusual circumstances.

Under Audit CAP, the plan is under examination, the plan sponsor corrects the mistakes and enters into a Closing Agreement with the IRS.

The plan sponsor pays a sanction that has been negotiated with the IRS and is based on the sum for all open taxable years of the Maximum Payment Amount that is determined by adding:

- 1) Additional income tax, and interest and penalties, that the employees would have to pay if contributions to their SEP-IRAs were included in their income and
- 2) Additional tax resulting from the 6% tax on excess contributions to IRAs.

The sanction paid under Audit CAP is greater than the fee paid under VCP.

Envision your car breaking down on the freeway and being towed to the shop....

# Issue #1 – Plan Amendment

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Has your SEP been amended for current law? <a href="#">(More)</a>	Determine if your Form 5305-SEP is the current revision (December 2004). <a href="#">(More)</a>	EPCRS Adopt revised Form 5305-SEP. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Maintain regular contact with the company that sold you the plan. <a href="#">(More)</a>

## **Slide 5**

Now let's get into the details of each of the five mistakes we commonly find in SEPs. This slide shows the SEP Fix-It Guide and the first potential mistake - Has your SEP been amended for current law?

Laws related to retirement plans change quite frequently. There are statutory deadlines for which many provisions must become effective. The IRS generally establishes a firm deadline for adopting these changes. Also, these law changes might mean your client can simplify some areas of plan administration or improve benefits. Your client will need to change plan language and then operate it accordingly to keep the plan within the law.

### **How to Find this Mistake:**

At some point in the plan's existence, your client may be asked to demonstrate its plan has complied with current and prior law. This request may come from a financial institution, plan service provider or it may come from the IRS during an audit.

Earlier, we talked about some of the ways that an employer can adopt a SEP - using Model Form 5305-SEP or a prototype plan, both of which have already been reviewed favorably by the IRS. If the plan is a Model Form 5305-SEP that is the current December 2004 revision, you can be assured that it complies with the law. If the plan is a prototype plan, you have a level of assurance that the plan has been updated for current law. Individually designed SEPs must also be updated for law changes. If this is your situation, you may want to consult a benefits professional.

### **How to Fix this Mistake:**

If you find your client has not amended its plan timely for the various law changes, it should adopt amendments for the law changes it has missed. Your client can do this by adopting a prototype plan approved for EGTRRA or a current IRS Form 5305-SEP, which has a revision date of December 2004. You will need to confirm that the plan's operation is consistent with the terms of the updated plan.

Let's look at an example:

Employer Y established a SEP in 1995 using a prototype plan and never subsequently amended for any law changes. Starting in 2002, the plan began using the increased contribution limits of EGTRRA. Due to the changes made by EGTRRA and other laws, the IRS issued revised Model Form 5305-SEP documents in 2002. If an employer was using a pre-EGTRRA Model SEP and wanted to take advantage of the EGTRRA changes in the 2002 plan year, then it should have adopted the revised Form 5305-SEP by the end of the 2002 plan year. The rules for prototype adopters are a bit different. The

employer should have adopted the EGTRRA-approved document within 180 days after the IRS issued a favorable EGTRRA opinion letter to the sponsoring organization of the prototype SEP.

Employer Y in this example would have to adopt an EGTRRA-revised document within 180 days after the IRS issued a favorable EGTRRA opinion letter to the sponsoring organization of the prototype SEP. If any of these conditions were not satisfied, then EPCRS would have to be used to correct the mistake by adopting the proper document.

So if your client has this mistake, which Correction Programs are available?

Your client may not correct this type of mistake under the Self-Correction Program. As we stated earlier, SCP is limited to operational problems, and this mistake is the result of not keeping the plan language up to date. In order to retain plan qualification, your client must correct this mistake under VCP.

Your client can make a VCP submission to the IRS identifying the mistake. The fee for correcting this mistake would be \$250.

If the IRS discovers this mistake on audit, your client may correct it under Audit CAP. The method of correcting this mistake would be the same as under VCP, but the sanction under Audit CAP is a percentage of the Maximum Payment Amount and would be greater than \$250.

### **How can you help your client avoid this mistake?**

There are a number of ways:

- Do an annual review of the plan document.
- When the plan document is amended, check the language against the old document, noting any differences.
- Knowing the plan has been properly updated may not be a simple process. Certain plans must be individually amended for each change, while others may have a prototype document that is amended. We recommend that your client maintain regular contact with the company that sold it the plan, if applicable. If the company sends your client a set of amendments to formally adopt, make certain it timely executes the documents per their instructions. Keep signed and dated copies of the plan document and any amendments for your client's records.

# Issue #2 – Eligible Employees Participating

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
2) Are all eligible employees participating in the SEP? <a href="#">(More)</a>	Review the section of your plan document concerning eligibility and participation. Check when employees are entering the plan. <a href="#">(More)</a>	EPCRS Apply reasonable correction method that would place affected employees in the position they would have been in if there were no operational plan mistakes. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	You should review the participation status of all employees at least once a year. <a href="#">(More)</a>

## Slide 6

Our next potential mistake is - Are all eligible employees participating in the SEP?

Your client must allow all eligible employees to participate, including part-time employees, seasonal employees and employees who die or terminate employment during the year. An eligible employee is an employee who is at least 21 years of age and has performed service for your client in at least three of the immediately preceding five years. The term "employee" includes a self-employed individual who has earned income and a working business owner. In addition, certain leased employees are "employees."

The SEP document can provide for less restrictive eligibility requirements, but not more restrictive. "Service" means any work performed for your client for any time, however short. A SEP may not impose an hours-of-service requirement.

There are also employees who the employer does not need to cover under a SEP. They are employees covered by a union agreement whose retirement benefits were bargained for in good faith by your client and their union, nonresident alien employees who didn't earn U.S. income from your client and employees who received less than \$550 in compensation during the year. This amount is subject to cost-of-living adjustments.

When your client determines which employees should be in the SEP, "employees" includes all employees of all related employers, including controlled groups of corporations that include your client's business, trades or businesses under common control with your client's business, and affiliated service groups that include your client's business. This means, for example, that if your client and/or his or her family members own a controlling interest in another business, employees of that other business are "employees" for purposes of determining who is eligible to participate in the SEP.

Let's look at some examples:

Example 1: Employer X maintains a calendar year SEP where an employee must perform service in at least three of the immediately preceding five years, reach age 21, and earn the minimum amount of compensation during the current year. Ann worked for Employer X during her summer breaks from school in 2005, 2006 and 2007, but never more than 34 days in any year. In July 2008, Ann turned 21. In August 2008, Ann began working for Employer X on a full-time basis, earning \$12,000 in 2008. Ann is an eligible employee in 2008 because she met the minimum age requirement, worked for Employer X in three of the five preceding years and met the minimum compensation requirement for 2008.



Example 2: Employer Y designs its SEP to provide for immediate participation regardless of age, service or compensation. Bob is 18 years old and began working part-time for Employer Y in 2008. Bob is an eligible employee for 2008.

To find this mistake, complete the following steps. Review the section of the plan document concerning eligibility and participation. Check when employees are entering the plan. Make a list of all employees who received a W-2. Compare their dates of hire and annual compensation against the eligibility and participation requirements in the plan document. Determine when each employee is entitled to become a participant in the plan according to the plan document. Inspect payroll and plan records to make certain the employees entered the plan timely.

### **How to Fix the Mistake:**

Generally, if your client did not provide an employee the opportunity to participate in its SEP plan, it must make a contribution to the plan for the employee that compensates for the missed contribution. The corrective contribution is intended to place the employee in the same position had he participated in the plan timely.

Let's look at an example.

Employer D maintains a SEP plan that provides for discretionary employer contributions, that it allocates on a comp-to-total-comp basis. For 2007, Employer D contributed an amount to the plan. However, Employer D inadvertently excluded Joe, who met the eligibility requirements, from participating in the plan. Joe had terminated during the plan year and did not receive an allocation of the contribution. The contribution resulted in an allocation for each of the eligible employees, other than Joe, equal to 10% of compensation. If Joe had shared in the original allocation, each employee would have received an allocation of 9% of compensation.

The EPCRS Revenue Procedure provides two different methods for correcting the exclusion of eligible employees. Only one of these methods, the contribution method, is proper for SEPs in most cases since the plan assets are held in IRAs. The contribution method requires the employer to make a corrective contribution based on the excluded employees' compensation to the plan. The corrective contribution must be adjusted for earnings. No adjustments are made to the employees who shared in the prior allocation, even though their allocations would have been different had the excluded employee not been excluded. For our example, Employer D would contribute an amount that equals 10% of Joe's compensation for the 2007 year (adjusted for earnings), and does not adjust the 10% allocations that were made to the other employees.

### **Which Correction Programs are available for this mistake?**

The example illustrates an insignificant operational problem, in that Employer D failed to follow the terms of the plan by not giving one employee an allocation of the contribution to the plan for the 2007 year. Therefore, if the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the mistake. There are no fees for self-correction and D must have practices and procedures in place.

Under VCP, correction would be the same. Employer D would make a VCP submission to the IRS and pay a fee of \$250. *Note to Speakers: Mention streamlined procedures Appendix F – Schedule 3 for SEPs; Schedule 4 for SIMPLE IRAs – Fillable on the Internet.*

Under Audit CAP, correction would be the same. Employer D and the IRS would enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How can you advise your client to avoid this mistake? Your client should review the participation status of all employees at least once a year. The person assigned the task should have a good understanding of the eligibility requirements and have access to the employment and payroll records necessary to make eligibility decisions for all employees.

# Issue #3 – Only Business

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
3) Is the business that the SEP covers the only business that you own? <a href="#">(More)</a>	You should identify any companies that you own or with which you have a financial relationship. <a href="#">(More)</a>	EPCRS Corrective contribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Determine if you own any other businesses. <a href="#">(More)</a>



## Slide 7

Our third mistake - Is the business that the SEP covers the only business your client owns?

As we previously stated, “employees” for purposes of determining who is an eligible employee under a SEP includes all employees of all related employers to your client’s business. This would include controlled groups of corporations, trades or businesses under common control and affiliated service groups. This means, for example, that if your client and/or your client’s family members own a controlling interest in another business, employees of that other business are “employees” for purposes of determining who is eligible to participate in a SEP.

### **How to Find this Mistake:**

All owners or partners of your client’s business should identify any companies that they own or with which they have a financial relationship. If any of these companies or relationships exist, the requirements of Code §§414(b), (c), and (m) should be scrutinized to ensure that all required employees are included in the plan.

### **How to Fix this Mistake:**

Generally, if your client did not provide an employee the opportunity to participate in its SEP plan, your client must make a contribution to the plan for the employee that compensates for the missed contribution, adjusted for earnings. The corrective contribution is intended to place the employee in the same position had he or she participated in the plan timely.

Let’s look at an example. An employer owns a restaurant that has 40 employees. The employer also owns a bakery that has 30 employees. The employer established a SEP plan in 2007 and only the eligible employees from the restaurant were included in the plan.

Applying the controlled group rules, the 30 employees of the bakery would be eligible employees because the employer owns both the restaurant and the bakery. Because the bakery employees were improperly excluded, they would have to receive allocations using the contribution method described earlier in mistake #2 or an alternative correction method that satisfies the general correction principles in the EPCRS Revenue Procedure.

**Which Correction Programs are available for this mistake?** The example illustrates a significant operational problem, in that the employer improperly excluded all of the bakery employees. Because this example is a significant operational failure, SCP is not available for the mistake and the employer must correct it using VCP.

Under VCP, correction would be a corrective contribution to all excluded employees. The employer would make a VCP submission to the IRS and pay the VCP submission fee of \$250. *Note to Speakers: Mention streamlined procedures Appendix F – Schedule 3 for SEPs; Schedule 4 for SIMPLE IRAs – Fillable on the Internet.*

Under Audit CAP, correction is the same. The employer and the IRS would enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

**How do you advise your client to avoid making this mistake?**

Your client should follow the steps described earlier in mistake #2 and should include determining if all owners or partners of your client's business owned any other businesses.

# Issue #4 – Compensation

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
4) Are you determining each eligible employee's compensation using the definition in your SEP document? <a href="#">(More)</a>	To determine if you are using the proper compensation for allocations, you'll need to review the plan document. <a href="#">(More)</a>	EPCRS Correction is based upon the terms of the plan and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	When calculating allocations, it is important for you to carefully review the plan terms to ensure that the correct amount of compensation is being considered. <a href="#">(More)</a>

## **Slide 8**

Our next mistake – Is your client determining each eligible employee's compensation using the definition in its SEP document?

A plan's definition of compensation is very important in determining the amount of contributions because they are often based on a percentage of compensation. Compensation generally includes the pay an employee received from your client for personal services for a year including wages and salaries, fees for professional services and other amounts received (cash or non-cash) for personal services actually rendered by an employee. The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2009 and is subject to cost-of-living adjustments for later years. Your client must follow the definition of compensation stated in the plan document in the operation of its plan.

### **How to find this mistake:**

To determine if your client is using the proper compensation for allocations, you'll need to refer to the plan document. Spot-check allocations to see if your client is using the correct compensation. Some of these definitions can get very complicated with expense reimbursements, car allowances, bonuses, commissions and overtime pay that is included or not included in the definition of compensation. If the plan has a complicated definition of compensation, develop a worksheet to calculate the correct amounts. If your client is using the Form 5305-SEP, make sure it is basing allocations on total compensation.

To fix this mistake, your client would make a corrective contribution, including earnings, for the affected employees.

For example, Employer G operates a restaurant with 15 employees. Under the terms of the SEP document, compensation for determining allocations of the employer contribution is defined as total wages earned including bonuses, tips and other income reported on the Form W-2. Since the inception of the plan, Employer G included bonuses and other income for the contribution allocation, but did not include tips.

Employer G should correct the allocations using the contribution method discussed earlier under mistake #2.

### **Which Correction Programs are available for this mistake?**

The example illustrates an operational problem, in that Employer G failed to follow the plan's definition of compensation by not including tips and used an incorrect amount to determine allocations under the plan. Therefore, if the other eligibility requirements

of SCP are satisfied, Employer G may use SCP to correct the mistake. There are no fees for self-correction and G must have practices and procedures in place.

Under VCP, correction is the same. Employer G would make a VCP submission to the IRS and pay a fee of \$250. *Note to Speakers: Mention streamlined procedures Appendix F – Schedule 3 for SEPs; Schedule 4 for SIMPLE IRAs – Fillable on the Internet.*

Under Audit CAP, correction is the same. Employer G and the IRS would enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

### **How to Avoid the Mistake:**

When calculating allocations, it is important for your client to review carefully the plan terms to ensure that it is using the correct amounts of compensation. If necessary, your client may wish to include in its payroll program an account that accumulates the proper compensation figures for plan purposes.



# Issue #5 – Contribution Limits

-----Trends-----	-----Tips-----			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
5) Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code (Code)? <a href="#">(More)</a>	Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2009). <a href="#">(More)</a>	EPCRS Correction for a failure to limit contributions allocated to employees is to either distribute or retain the excess amount. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	After the initial calculation of allocations based on the terms of the plan, you should check to make sure none of the proposed allocations would violate the Code. <a href="#">(More)</a>

## Slide 9

Our last potential mistake is - Are SEP contributions to each employee's IRA limited as required by the Internal Revenue Code?

All SEP contributions are employer contributions. Section 415 of the Code limits the amount of contributions made to an employee's SEP-IRA to the lesser of \$49,000 in 2009 (subject to cost-of-living adjustments for later years) or 100% of the eligible employee's compensation. However, in order for the employer to get a deduction for SEP contributions, no more than 25% of employees' compensation can be contributed each year. The amount of compensation taken into account is limited to \$245,000 in 2009 (subject to cost-of-living adjustments for later years). If the SEP plan document specifies lower contribution limits, then the lower limits control.

There are special rules if an individual is self-employed. When calculating the deduction for contributions made to a self-employed individual's SEP-IRA, compensation is the individual's net earnings from self-employment, which is reduced by both the deduction for one-half of his or her self-employment tax and the deduction for contributions to his or her own SEP-IRA. For this reason, you determine the deduction for contributions to a self-employed individual's SEP-IRA indirectly by reducing the contribution rate called for in the plan. For more information on the deduction limitations for self-employed individuals, see Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*.

### **How to Find this Mistake:**

Calculate 25% of each employee's compensation and compare the total contribution made for the employee to the lesser of that amount or the dollar limitation for that year (\$49,000 in 2009). Review the special calculations in Publication 560 for self-employed individuals.

### **How to Fix the Mistake:**

There are two alternative methods to correct excess employer contributions to employees. They are:

- 1) A plan sponsor may effect a distribution of the excess amount, adjusted for earnings, through the date of correction. The earnings adjustment is based on the actual rate of return of the SEP-IRA from the date the excess employer contribution was made through the date of correction. The amount returned to your client is not includible in the gross income of the affected employee. The plan sponsor would not be entitled to a deduction for the excess contribution. The trustee of the SEP-IRA should report the amount returned on Form 1099-R as a distribution issued to the affected employee, indicating the taxable amount as zero.

- 2) The amount in excess of the limit may be retained in the SEP-IRA. This correction method is available under VCP and requires an additional fee. The fee is equal to at least 10% of the excess amount excluding earnings. The excess amount, adjusted for earnings through the date of correction, must reduce the affected employees' limit for the year of correction and subsequent years, until the excess is eliminated.

For example, Employer H maintains a SEP plan. For the 2007 year, the contributions made for two employees, Tom and Will, exceeded the limit. Tom had an excess of \$3,000 and Will had an excess of \$300.

### **Which Correction Programs are available?**

The example illustrates an operational problem, in that Employer H failed to follow the terms of the plan by exceeding the limits in the plan document and the Code. Therefore, if the other eligibility requirements of SCP are satisfied, Employer H may use SCP to correct the failure by using the distribution-of-excess-amounts correction method. There would be no fee for self-correction and H must have practices and procedures in place.

Under VCP, correction under the distribution-of-excess-amounts method is the same. Employer H would make a VCP submission to the IRS and pay the VCP submission fee of \$250. If your client makes correction under the retention method by retaining the excess amounts in the SEP-IRA, the EPCRS Rev. Proc. imposes an additional fee equal to at least 10% of the excess amount excluding earnings in addition to the \$250 submission fee.

Under Audit CAP, correction is the same. Employer H and the IRS enter into a Closing Agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

### **How to Avoid the Mistake:**

After an employer makes the initial calculation of allocations based on the terms of the plan, your client should check to make sure none of the proposed allocations would violate §415 of the Code or the 25% limit contained in all SEP plans. Make the calculation based on the plan language. Check this against the §415 rules and the 25% limit before the actual allocation is made to the SEP. If there is a problem, your client can adjust it before it transfers the money into the SEP accounts.

# Other Fix-It Guides and Resources

- 401(k) Fix-It Guide
- SIMPLE IRA Plan Fix-It Guide
- SARSEP Fix-It Guide
- Correcting Plan Errors web page
  - All can be found at [www.irs.gov/ep](http://www.irs.gov/ep)



## Slide 10

We have focused on the most frequent problems that we see in SEP plans and how to find, fix and avoid these problems in today's session. We also have Fix-It Guides for 401(k), SIMPLE IRA and SARSEP plans to help you and your clients find, fix and avoid mistakes in these types of plans. You can easily view or download these guides on our web site, [www.irs.gov/ep](http://www.irs.gov/ep). They are a great resource to help you explain mistakes to your clients and to emphasize their need to fix these mistakes sooner rather than later. Additionally, you can find more in-depth information on correcting plan errors on our "Correcting Plan Errors" web page.

Maybe after reviewing the SEP Fix-It Guide, you or your client may find that a SEP is not the right plan for them. We have a publication, *Choosing a Retirement Solution for Your Small Business*, which may help your client choose a plan that better fits their needs.



# Retirement Plan Assistance

- [www.irs.gov/ep](http://www.irs.gov/ep)
  - Includes pages dedicated to Fix-It Guides and Correcting Plan Errors
- (877) 829-5500
  - Customer Account Services
- [RetirementPlanQuestions@irs.gov](mailto:RetirementPlanQuestions@irs.gov)
- Newsletters

## Slide 11

We have developed many tools to assist you and your clients with retirement plans, whether your question is “How do I choose a retirement plan?” or “How much money can I contribute to my retirement plan?” or “This plan isn’t working for me anymore. How do I terminate it?”

You can visit our web site at [www.irs.gov/ep](http://www.irs.gov/ep). Or you can find the [Retirement Plans Community](#) web page on the main [www.irs.gov](http://www.irs.gov) landing page. You will find information for “Benefits Practitioner,” “Plan Participant/Employee” and “Plan Sponsor/Employer.” The pages contain all of the retirement plan information that you have come to expect from EP. Be sure to check our new Participant page that contains a tremendous amount of information in plain language to answer plan participant’s questions about their retirement plans. You will find pages dedicated to the IRS Fix-It Guides and Correcting Plan Errors, in addition to many other resources to help you keep your client out of trouble with the IRS.

There are two different ways that you can discuss your questions with a retirement plan specialist. You can call our Customer Account Services toll-free at (877) 829-5500 or, if you prefer, you can e-mail your questions to [RetirementPlanQuestions@irs.gov](mailto:RetirementPlanQuestions@irs.gov). Our specialists must respond to all e-mail questions by telephone, so please remember to include your phone number and a customer service representative will call you with the answer to your questions.

Finally, we have two free, quarterly electronic newsletters you can subscribe to. The first is the *Employee Plans News*. This newsletter is geared toward the practitioner community and is more technical and involved than our newsletter geared toward plan sponsors, *Retirement News for Employers*. Being a web-based product, the newsletters make an excellent reference guide as we fill them with embedded links to source materials

Subscribing to these newsletters will keep you and your clients current with all the latest news regarding retirement plans and it is easy. Just go to “Newsletters” in the left pane of our web page, click on “Employee Plans News” or “Retirement News for Employers,” click on “Subscribe,” then provide us with your e-mail address. That’s all it takes.

You will receive a message in your e-mail inbox with a link directing you to the newsletter when we post our latest issue or Special Editions.



- Be sure to attend our session on Financial Distress and Retirement Plan Distributions
- Questions





## **Slide 12**

Please be sure to attend our presentation on “Financial Distress and Retirement Plan Distributions,” which will discuss how to help your clients avoid turning a bad financial situation into a tax disaster in these tough economic times when folks sometimes turn to their retirement plan savings for financial relief.

Thank you for your attention and please stop by the TE/GE booth for additional retirement plan information.

Questions?